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Financial Services Quarterly Reporting Update

July 8, 2021

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Today’s Presenters


Josh White


Mark Scriven


Robert Stevens


Matthew McFarlin


Marshall Trull


Chris Anderson

Today's Agenda

HUD Reporting Requirements

- Marshall Trull

Business Combinations

- Matthew McFarlin and Christopher Anderson

SEC/PCAOB Updates

- Robert Stevens and Josh White

Allowance for Credit Losses (ACL) & Allowance for Loan Losses (ALL)

- Mark Scriven

Questions

- Josh White

Polling Question

How was your 4th of July holiday?

A) Great!

B) So-so

C) Too busy closing out quarter end

HUD Regulatory Reporting

Marshall Trull, CPA, CRCM

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HUD Regulatory Reporting

Topics

- Applicability
- Related Updates
- Audit Requirements

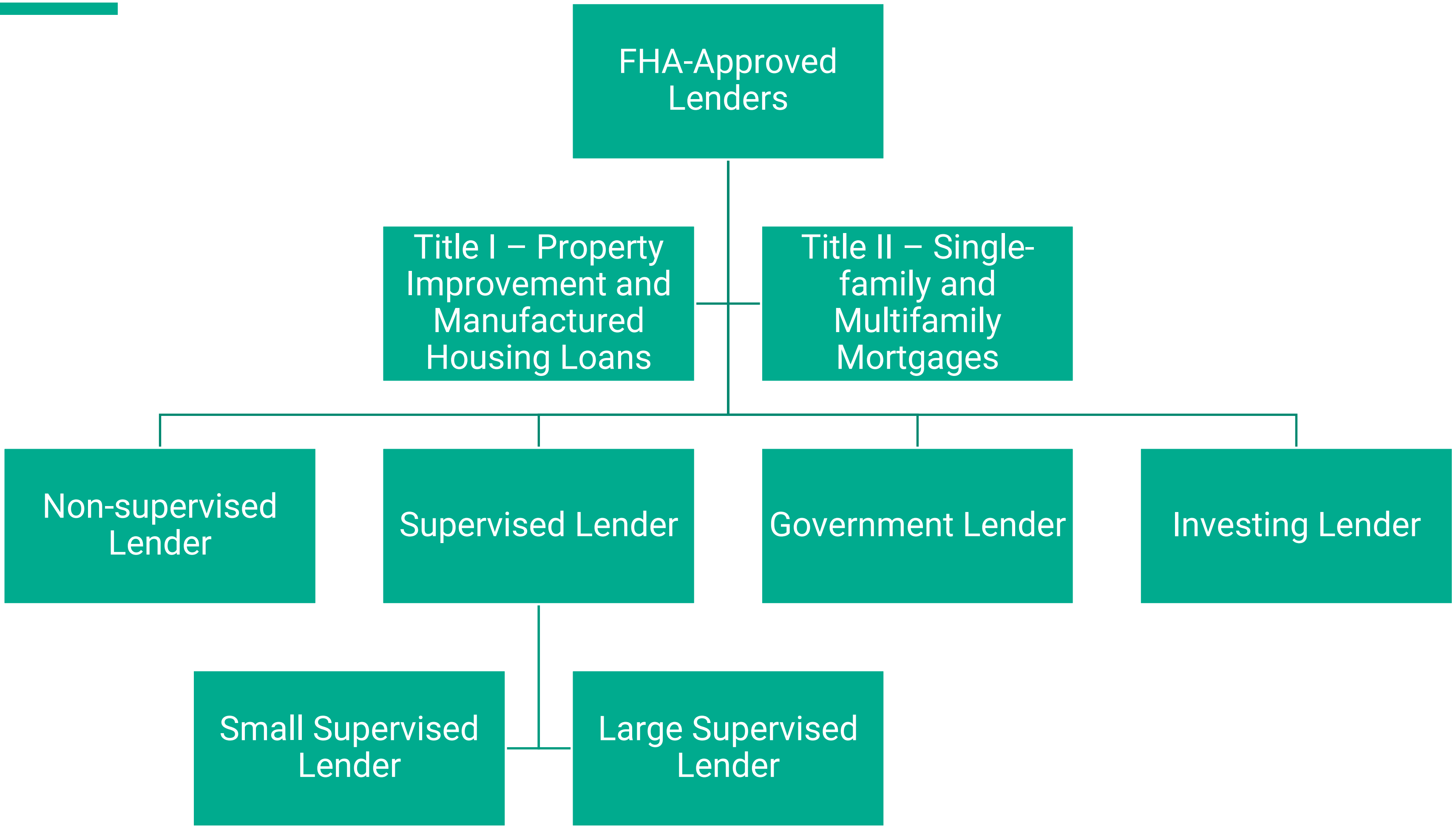
HUD Regulatory Reporting

Applicability

- Common Programs
    - FHA-Approved Lenders
    - Ginnie Mae Issuers of Mortgage Backed Securities (GNMA Issuers)
    - HUD Multifamily Housing Owners and Management Agency HUD Multifamily Hospital Program

HUD Regulatory Reporting

Applicability



Applicability

- Large Supervised Lenders
    - Required to have annual audit regardless of the number of loans originated or serviced
    - Required to be submitted within 90 days of close of fiscal year
    - Size determined based on thresholds for submitting audited financial statements by regulatory agencies ($500 million in consolidated assets)

Polling Question

Does your institution participate in a HUD Program?

A. Yes

B. No

C. I'm not sure

Related Updates

- FDIC – 12 CFR 363.1(a)
    - Consolidated total assets as of the beginning of the **fiscal** year are $500 million or more
    - For any **fiscal** year ending in 2021, based on the lesser of:
        - an insured depository institution's consolidated total assets as of December 31, 2019
        - an insured depository institution's consolidated total assets as of the beginning of its fiscal year ending in 2021

Related Updates

- NCUA – 12 CFR 715.4(c)
    - Amount of total assets filed for the **calendar** year-end immediately preceding the period under audit
    - $500 million audit requirement
    - No 2021 asset size exemption is mentioned

Audit Requirements

- Audit Reporting Package
    - Audit of the Financial Statements and Supplementary Information
    - Internal Control Report
    - Compliance Report
    - Schedule of Findings and Questioned Costs
    - Corrective Action Plan

Business Combinations

Matthew McFarlin, CPA
Christopher Anderson, CPA

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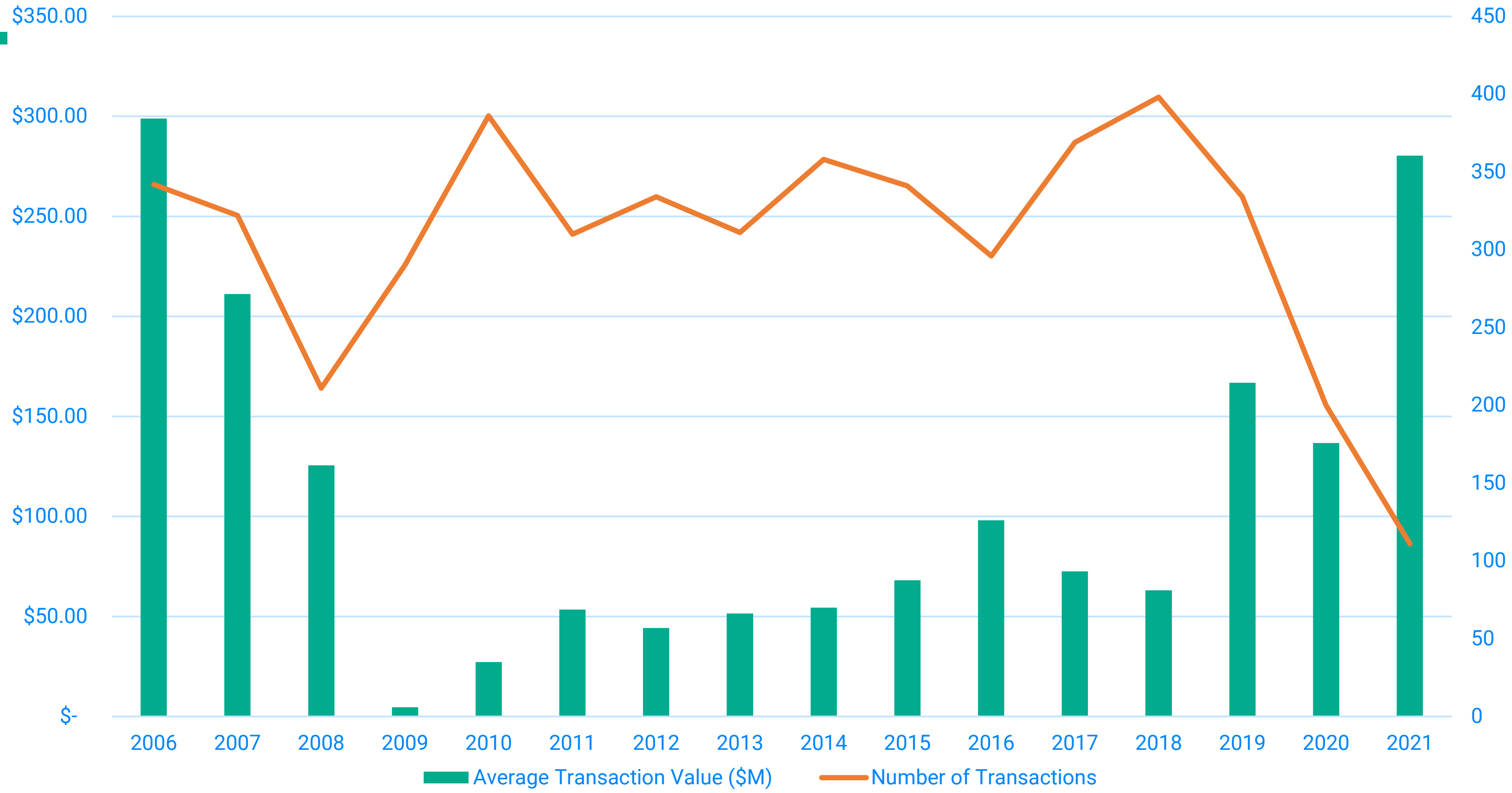
Agenda

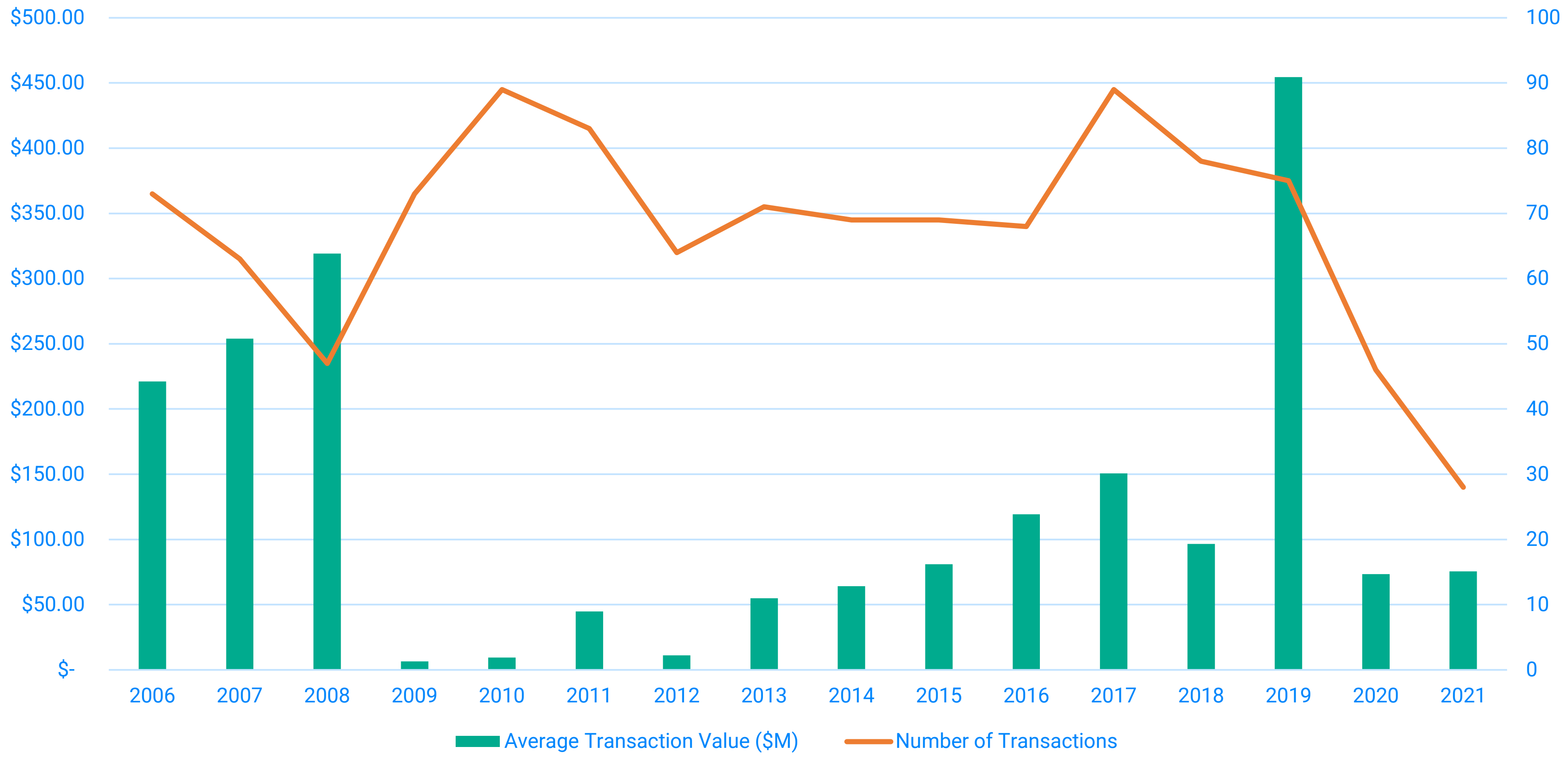
- M&A Activity
- Common areas where issues arise in business combinations:
    - Identifying the Acquirer
    - Valuation
    - Merger Related Expenses
    - Compensation Agreements
    - Internal Controls
    - Financial Statement Disclosures

Bank M&A Timeline (US)



Source: S&P Global Market Intelligence
*2021 Data is through June 30, 2021

Bank M&A Timeline (Southeast US)



Source: S&P Global Market Intelligence
*2021 Data is through June 30, 2021

Identifying the Acquirer

- In accordance with ASC 805 and 810, one of the entities would be identified as the acquirer in the transaction, for accounting purposes
- In a business combination effected primarily by exchanging equity interests, the acquirer usually is the entity that issues its equity interests
- Accounting acquirer is the entity that obtains control of the reporting entity, and recognizes the assets and liabilities of the target company at fair value in accordance with ASC 805
- The accounting acquirer may be different from the legal acquirer

Identifying the Acquirer, continued

- Other facts and circumstances considered in identifying the acquirer:
  - Voting Rights
  - Board Composition
  - Management Composition
  - Terms of the Deal
  - Size

Valuation

- Identifying assets acquired and liabilities assumed
  - Generally measured at fair value
  - The below list is not all-inclusive, but includes a few areas where questions typically arise

Carried at Fair Value, no mark typically needed	Marked through "Day 1" adjustment
Cash	Loans
Securities, available-for-sale	Allowance for Loan Losses (written-off)
Deposits (non-interest bearing)	Fixed Assets
Other Assets / Liabilities (perform analysis of items within these accounts for potential fair value adjustments needed)	Other Real Estate Owned
	Deposits (interest bearing)
	Borrowings

Valuation

- Loan portfolio valuation
  - Generally the bank’s largest asset
  - Valuation of loan portfolio consumes the majority of the valuation team’s effort
  - Achieving consensus on fair value can be challenging because there typically aren’t observable market prices for most portfolios
  - Unexpected changes could have an impact on regulatory capital and future earnings potential

Valuation, continued

- Valuation of the portfolio is typically performed using a discounted cash flow method, with various assumptions such as probability of default, loss given default, prepayment speeds, etc.
  - Plan for the post-acquisition accounting process in advance of deal completion
  - Accounting for loans after the deal has closed can be complicated and may require systems, processes and coordination with various teams within the bank
  - Proper planning on the front end and coordination with a vendor can result in due diligence expectations that are consistent with post-completion valuations

Merger Related Expenses

- Examples:
  - Direct Costs: 3rd party costs, including finders' fees, advisory, legal, accounting, valuation, and other professional or consulting fees
  - Indirect costs: general administrative costs, including the cost of maintaining an internal acquisitions department
  - Financing costs: costs of issuing debt or equity securities to finance the acquisition
- Generally recorded by the buyer unless they specifically relate to expenses in the ongoing operations of the seller
  - An exception is certain employment contracts, which need to be evaluated on a contract by contract basis
- Core provider agreement termination fee: generally recorded by the acquirer

Compensation Agreements

- Single Trigger
  - Solely triggered upon change in control
    - Recorded by the seller
- Double Trigger
  - Triggered by change in control & termination of the employee (or other event triggered by the buyer)
    - Recorded as compensation expense in the post-acquisition financial statements of the combined company

Compensation Agreements – Example 1

- Target hired a chief executive officer (CEO) pursuant to a five-year employment contract
- Target will pay $1 million to the CEO in the event Target is acquired by another company and the CEO remains employed through the acquisition date
- Acquirer acquires Target two years after the employment contract is signed
- The CEO was employed at the acquisition date and will receive the $1 million payment under the existing contract
- Should be recorded by the Target as a pre-combination expense

Compensation Agreements – Example 2

- Assume same facts as included in Example 1, except that the employment contract with the CEO was executed at the suggestion of Acquirer during the negotiations for the business
- If it was determined that the arrangement was to provide severance pay to the CEO, the Acquirer would record the payment as compensation expense in the post-acquisition financial statements of the combined company

Compensation Agreements – Example 3

- Target hired an executive pursuant to a five-year employment contract
- Target is required to pay $100,000 to the executive in the event that (1) Target is acquired and (2) the executive's employment is terminated or his responsibilities or salary are reduced significantly (as defined in the employment agreement) subsequent to the acquisition
- Acquirer acquires Target two years after the employment contract was signed with Target and on the acquisition date, enters into a new employment contract with the executive which significantly reduces the executive's salary. As a result, the executive will receive the $100,000 payment
- Record the payment as compensation expense in the post-acquisition financial statements of the combined company

Internal Controls

- Although business combinations are non-routine transactions, this does not preclude a company from establishing controls over the transaction
- Controls around specialists are also needed. Using a 3rd party valuation specialist does not excuse management from incorporating controls over the process and taking responsibility for the work of the specialist
- Process should be documented to obtain an understanding of the likely sources of potential misstatements
- Evaluate controls over system generated data or reports used in the combination process
- Assess / test operating effectiveness of controls
- Consolidate key controls post merger/conversion

Internal Controls – Additional Considerations

- Below are a few examples of what could go wrong. Controls should be designed and implemented to mitigate these risks:
  - Acquisition is not approved and authorized
  - Assets and liabilities recorded in the acquisition do not exist
  - Journal entries are not properly recorded
  - Accounting not in accordance with GAAP
  - Acquired assets are not properly valued at acquisition date
  - All intangible assets are not identified
  - Data inputs and assumptions used in the valuation are not accurate
  - Footnote disclosures do not meet GAAP requirements

Disclosures

- Disclosure requirements are spread across three Subtopics of the Codification:
  - 805-10-50, 805-20-50, 805-30-50
- Requirements include:
  - Pro-forma information (public business entities only)
  - Recognition of purchase consideration, fair value of net assets acquired, and goodwill/bargain purchase gain recognized
  - Transaction details:
    - Reason for the transaction
    - Transaction expenses
    - Other transactions entered into in close proximity

Polling Question

In your experience with business combinations, in which area do issues typically arise?

A) Valuation

B) Merger-related expenses

C) Internal control integration

D) Other

SEC/PCAOB

Robert Stevens, CPA

Josh White, CPA, CFIRS

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SEC Auditor Independence Guidance

- Focus on relationships that are most likely to threaten impartiality
    - Most recent year presented in audited financial statements
    - Debtor-creditor provisions for consumer loans
    - Independence issues brought about by mergers
    - Definition of "Affiliate of the Audit Client"

SEC Auditor Independence Guidance

- Office of the Chief Accountant (OCA)/SEC difference of opinion
  - Application of Rule 2-01(b) unchanged (all periods filed are considered for independence discussions)
  - Undermines updated provisions contained within 2020 guidance
  - Ultimately, auditors cannot re-audit their own work
    - "OCA has received questions regarding auditor independence in de-SPAC mergers, including related to partner rotation requirements and fact patterns where the auditor had prior involvement in the preparation of the financial statements of the target company. It is important to understand that the general standard of independence applies to all periods including in a registration statement. Under the general standard, an auditor is not independent if, among other things, he or she would be in a position of auditing his or her own work or if he or she acts as management."

SEC Climate and ESG Initiatives

- Greater investor focus and scrutiny on climate and environmental, social and governance (ESG)-related disclosures
- March 2021 SEC announcements
    - Greater focus on climate-related risks in examinations
    - Enforcement task force focused on ESG and climate issues
    - Requested comments regarding climate change disclosures – over 5,700 comments received
- Also, legislation in the works requiring expanded climate and ESG disclosures

SEC Climate and ESG Initiatives

- Emission levels:
    - Scope 1 – Direct greenhouse gas emissions from an organization
    - Scope 2 – Indirect emissions from purchase of energy
    - Scope 3 – Indirect emissions within an organization’s value chain
- Concerns from banking industry about disclosing Scope 3 emission data that would need to be obtained from borrowers/customers
- Scope 3 will be a challenge, particularly for community banks lending primarily to privately held customers

Polling Question

Does your institution collect any climate-related data?

A) Yes, Scope 1

B) Yes, Scope 2

C) Yes, Scope 3

D) Yes, all of the above

E) No

PCAOB Update

- 2021 exam focus on audit firms' response to COVID-19 in audits.
  - Impacted industries are more likely to be selected
  - The impact of audit quality on work limitations due to the pandemic
- Critical audit matters
  - Not effective for emerging growth companies (EGC)
  - PCAOB opinion prior to become a public company does not qualify as an EGC

SEC and PCAOB - Links

- SEC Response to Climate and ESG Risks and Opportunities
- American Banker – Big banks support SEC climate disclosure plan, small banks dread it
- American Banker – Why SEC's climate disclosure rules could hit banks the hardest
- PCAOB – Staff Observations and Reminders during the COVID-19 Pandemic
- PCAOB – Implementation of Critical Audit Matters: The Basics

Allowance for Credit Losses (ACL) & Allowance for Loan Losses (ALL)

Mark Scriven, CPA

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Allowance for Credit Losses & Allowance for Loan Losses

Presentation Topics

- Recent Credit and Reserve Trends
- Considerations for Current Expected Credit Losses (CECL)

Recent Credit and Reserve Trends

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Recent Credit and Reserve Trends

- Fourth Quarter 2019
- CECL Implementation – Early Adopters
- COVID Impact
- Q1’2021 and Go-Forward Forecasts

Polling Question

What are your plans for allowance for loan losses / allowance for credit losses during the duration of 2021?

A. We already released reserves during Q1’2021 and plan to hold at a consistent level through the rest of the year

B. We expect to have a negative provision during an upcoming quarter

C. We expect to maintain our Q4’2020 reserve coverage through 2021

D. We expect to continue provisioning through the rest of 2021

Considerations for Current Expected Credit Losses (CECL)

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Considerations for CECL

- Institutions that have already implemented CECL
    - (Re) evaluate key model assumptions
    - Macroeconomic environment / forecasting
    - Model validations

Considerations for CECL

- Institutions that have not yet adopted CECL
    - Compile historical loan information (more than just loss history)
    - In-house model vs. 3rd party provider
    - Determine model methodology and macroeconomic variables for forecasting
    - Model validation
    - Documentation
    - Scaled CECL Allowance for Losses Estimator (SCALE) → Federal Reserve

Polling Question

Which of the following items was the most difficult when implementing CECL?

A) Choosing whether to utilize a model provider or complete the model in house

B) Choosing an appropriate model methodology

C) Obtaining historical loan information for use within the model

D) Understanding key model assumptions and the forecasting component

E) I don’t know – I’m still in the beginning stages of understanding CECL

Questions?

We’re here to help!

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Upcoming Financial Services Group Webinars

Register for these & all other Elliott Davis webinars at www.elliottdavis.com/events

Sept. 16, 2021

FSG Credit Risk/Loan Review Webinar

October 7, 2021

Financial Services Quarterly Reporting Update – 3rd Quarter 2021

January 13, 2022

Financial Services Quarterly Reporting Update – 4th Quarter 2021

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